

**Office of Chief Counsel
Internal Revenue Service
Memorandum**

Number: **200844011**

Release Date: 10/31/2008

CC:INTL:B05: MKHarris
POSTF-112559-07

UILC: 4371.03-00, 7701.00-00

date: July 21, 2008

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subject: Application of Section 4371 Excise Tax to Reinsurance Premiums

This Chief Counsel Advice responds to your request for assistance dated May 11, 2007.
This advice may not be used or cited as precedent.

LEGEND

Taxpayer =
Parent =
Pool =
Contract =
Country X

ISSUES

Whether amounts paid by Taxpayer to an insurance pooling arrangement were premiums paid with respect to a policy of insurance, indemnity bond, annuity contract, or policy of reinsurance to a foreign insurer or reinsurer that are subject to excise tax under section 4371 of the Internal Revenue Code (Hereinafter all section references are to the Internal Revenue Code or regulations promulgated under the "Code")?

CONCLUSIONS

Section 4371 of the Code applies to amounts paid by Taxpayer to Pool because those amounts were premiums paid with respect to a policy of insurance, indemnity bond, annuity contract, or policy of reinsurance to a foreign insurer or reinsurer.

FACTS

Parent, a US company, is head of a US consolidated group of corporations. Parent and its subsidiaries buy insurance covering its US assets, workman's compensation, and US commercial liabilities. Parent obtains catastrophic insurance from unrelated insurance companies covering large claims. Parent buys insurance from Taxpayer, a wholly-owned subsidiary covering its small claims.

Taxpayer is incorporated in Country X and has filed an election under section 953(d) of the Code to be treated as a domestic corporation. Taxpayer's gross receipts primarily consist of insurance premiums received on policies issued to Parent and its subsidiaries. Taxpayer is responsible for all claims greater than \$100,000 up to the large claim limits covered by unrelated insurance companies. Taxpayer is a member of a pooling arrangement (Pool) and cedes insurance on any claims less than \$100,000 to the Pool in accordance with a contract (Contract).

Each year, as a member of the Pool, Taxpayer and other members enter into the Contract with a management company. The Contract sets out the terms and limitations of the insurance risks ceded and assumed by the Pool members executing the document. It also provides for the conduct of Pool business by members and the Manager, including (1) hiring an actuary to analyze risks for all members and set premium rates, (2) setting up the operation of committees and (3) establishing procedures under which new members may be included and certain old members ousted from the Pool. The Contract is governed and interpreted in accordance with the laws of Country X. The management company of the Pool is a Country X company.

The Pool operates separately from each member. Various committees oversee the business operations of the Pool. No single Pool member can prevent the Pool from acting on its determinations. The Participant's Committee, with concurrence of the Manager, has authority to determine all matters relating to the overall operation of the Pool. Each Participant at the time of admission must meet minimum qualifications to the satisfaction of the Participant's Committee. The Participant's Committee maintains an Executive Committee, Underwriting Committee, and Audit and Finance Committee. A Pool member may be terminated by the Manager at the direction of the Participant's Committee.

Under the Contract, each member of the Pool transfers its risk for all claims of \$100,000 or less to the Pool and agrees to assume a percentage of the risk for those claims of \$100,000 or less arising from the insurance risks of other Pool members. Members of the Pool are captive insurance companies of unrelated domestic companies. Thus, Taxpayer pays reinsurance premiums to the Pool, and assumes an equal amount of risk from the Pool, receiving reinsurance premiums equal in amount to premiums it paid to the Pool. Under the terms of the Contract, claims arising from policies written by Taxpayer that were ceded to the Pool are submitted by Taxpayer to the Pool (and, similarly, to other Pool members). The Pool reviews and approves these claims and provides a statement of amounts due to Taxpayer. It then bills Taxpayer for its participating percentage of the total claims submitted by all Pool members, which it has approved for payment. Thus, Taxpayer either received net income or incurred net loss depending on the amount of claims it submits to the Pool for payment each quarter in relation to the amount of claims submitted by other members of the Pool.

The quarterly net income/loss received by Taxpayer as a result of its participation in the Pool is reported on the Parent consolidated return. This income or loss resulted primarily from the netting of accrued claims costs, either those ceded or assumed (plus management fees and extraordinary expenses charged), since the premiums for the risk assumed and ceded netted to zero each year. Computation of these claims costs is based on Taxpayer's participation percentage in the Pool, which has to be determined actuarially at the "Pool level."

LAW AND ANALYSIS

Section 4371 of the Code provides for an excise tax on each policy of insurance, indemnity bond, annuity contract, or policy of reinsurance issued by any foreign insurer or reinsurer. Section 4371(1) imposes an excise tax of 4 cents on each dollar, or fractional part thereof, of the premium paid on a policy of casualty insurance or the indemnity bond, if issued to or for, or in the name of, an insured as defined in section 4372(d). Section 4371(2) provides for an excise tax of 1 cent on each dollar, or fractional part thereof, of the premium paid on the policy of life, sickness, or accident insurance, or annuity contract. Section 4371(3) provides for an excise tax of 1 cent on each dollar, or fractional part thereof, of the premium paid on the policy of reinsurance covering any of the contracts taxable under paragraph (1) or (2).

Section 4372(a) provides that the term "foreign insurer or reinsurer" means an insurer or reinsurer who is a nonresident alien individual, or foreign partnership, or a foreign corporation. For purposes of section 4371(3), the term "policy of reinsurance" means any policy or other instrument by whatever name called whereby a contract of reinsurance is made continued, or renewed against, or with respect to, any of the hazards, risks, losses, or liabilities covered by contracts taxable under paragraph (1) or (2) of section 4371. Section 4372(f). Section 4372(b) provides that the term "policy of casualty insurance" means any policy (other than life) or other instrument by whatever name called whereby a contract of insurance is made, continued, or renewed.

Whether an organization is an entity separate from its owners for federal tax purposes is a matter of federal tax law and does not depend on whether the organization is recognized as an entity under local law. Treas. Reg. §301.7701-1(a)(1). A joint venture or other contractual arrangement may create a separate entity for federal tax purposes if the participants carry on a trade, business, financial operation, or venture and divide the profits therefrom. Treas. Reg. §301.7701-1(a)(2).

There is no specific factor or set of factors to determine whether parties have entered into a partnership. In Culbertson, 337 U.S. 733, 742 (1948), the Supreme Court stated:

[c]onsidering all the facts – the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purpose for which it is used, and any other facts throwing light on their true intent – the parties in good faith and acting with a business purpose intend to join together in the present conduct of the enterprise.

Despite the Culbertson finding that a partnership is not defined by reference to any specific factors, the courts generally look at factors. Usually, the most important factor is evidence that the participants in an arrangement intended to join together to make and share profits as co-proprietors. Madison Gas & Electric Co. v. Commissioner, 72 T.C. 521 (1979), aff'd 633 F. 2d 512 (7th Cir. 1980).

The term “partnership” includes a joint venture. Subsequent to Culbertson, the Tax Court identified a number of factors bearing on the issue of whether an arrangement rises to the level of a joint venture. In Luna v. Commissioner, 42 T.C. 1067 (1964), the Tax Court suggested eight factors, none of which is conclusive, that bear on the issue of who is a partner in a partnership. These factors include (1) the agreement of the parties and their conduct in executing its terms, (2) the parties’ contributions to the venture, (3) the parties’ control over income and capital and their right to make withdrawals, (4) whether each party was a principal and co-proprietor sharing a mutual proprietary interest in the net profits and having an obligation to share losses (or whether one party was the agent or employee of the other), (5) whether the business was conducted in the joint names of the parties, (6) whether the parties filed federal partnership returns, (7) whether separate books of account were maintained for the venture, and (8) whether the parties exercised mutual control over and assumed mutual responsibility for the enterprise.

Section 7701(a)(2) defines the term “corporation” to include insurance companies. Insurance companies other than life are taxed under the provisions of § 831. Section 831(c) provides that for purposes of 831, the term “insurance company” has the meaning given to such term by 816(a). Section 816(a) (formerly 801) and the regulations under former section 801 are relied upon for purposes of defining insurance companies other than life. Section 816(a) defines an insurance company as a company

for which more than half of the business during the taxable years is the issuing of insurance or annuity contracts or the reinsuring of risk underwritten by insurance companies.

Treas. Reg. §1.801-3(a)(1) provides that, while the name, charter powers, and subjection to State insurance laws are significant in determining the business which a company is authorized and intends to carry on, it is the character of the business actually done in the taxable year which determines whether a company is taxable as an insurance company under the provisions of the Subchapter L of the Code (sections 801-846). Accordingly, by its terms, the definition of an insurance company in Treas. Reg. §1.801-3(a)(1) requires an entity that is engaged in the insurance business to be treated as an insurance company, regardless of the entity's legal form.

Rev. Rul. 83-132, 1983-2 C.B. 270, states that a noncorporate business entity that is primarily engaged in the business of issuing insurance contracts is an insurance company as defined Treas. Reg. § 1.801-3(a)(1), and therefore is taxable as a corporation under section 7702(a)(3). Rev. Rul. 83-132 considers the tax classification of a noncorporate entity that is engaged in the business of issuing insurance contracts through an insurance exchange. The insurance exchange was created by the state under the state statute which permitted noncorporate insurers, including partnerships and individuals, to operate on the insurance exchange. The insurers operating on the exchange are subject to the basic accounting rules imposed on all insurers under state law. Rev. Rul. 83-132 holds that the insurance exchange is a business entity primarily engaged in the business of underwriting and issuing insurance contracts. Accordingly, the noncorporate entity meets the definition of an insurance company under section 7701(a)(3). Thus, it is immaterial whether an organization is a partnership, proprietorship, or any other noncorporate form under state law, if an entity is primarily engaged in underwriting insurance risks.

A business entity (including an entity that is disregarded as separate from its owner under §301.7701-2(c)) is domestic if it is created or organized as any type of entity (including, but not limited to, a corporation, unincorporated associated, general partnership, limited partnership, and limited liability company) in the United States, or under the law of the United States or any State. Treas. Reg. §301.7701-5. A business entity (including an entity that is disregarded as separate from its owner under sec. 301.7701-2(c)) is foreign if it is not domestic. Treas. Reg. §301.7701-5.

The Contract, which is governed by and interpreted in accordance with the laws of Country X, provides for the conduct of an insurance Pool and the terms and limitations of the insurance risks ceded and assumed by the Pool members. The Contract sets forth the duties of the Pool members and Manager, including hiring an actuary to analyze risks for all members and set premium rates, setting up the operation of committees, and establishing procedures under which new members may be included and old members removed from the Pool. The Pool spreads the risk of loss for claims under \$100,000 among members of the Pool and permits the members to share

management fees for the operation of the Pool. In addition, separate books of account were maintained by the Pool. Finally, the members of the Pool exercised mutual control over the operations and management of the Pool through the Participant's committee.

Each member of the Pool enters into the Contract which sets out the terms and limitations of the insurance risks ceded and assumed by the Pool members. The Pool reinsures a portion of the insurance risk of each member and receives a reinsurance premium. The reinsurance premium is determined by an actuarial firm appointed by the Manager. Concurrently, the Pool member assumes an equal amount of risk from the Pool, receiving reinsurance premiums equal in amount to premiums it paid to the Pool. The Pool, through its Manager and Committees, assesses the risk it assumes and those it reinsures with other member insurers processes, approves and pays claims, and audits reserves.

The Pool operates separately from each member. Various committees oversee the business operations of the Pool. No single Pool member can prevent the Pool from acting on its determinations. The Participant's Committee, with concurrence of the Manager, has authority to determine all matters relating to the overall operation of the Pool. Each Participant at the time of admission must meet minimum qualifications to the satisfaction of the Participant's Committee. The Participant's Committee maintains an Executive Committee, Underwriting Committee and Audit and Finance Committee. A Pool member may be terminated by the Manager at the direction of the Participant's Committee.

The activities carried on by the Pool demonstrate that the pooling arrangement is more than a contractual arrangement between individual members. Instead, the Pool is a separate entity under Treas. Reg. §301.7701-1(a)(1). The Pool activities are indicative of business activities characteristic of insurance companies. Thus, based on the determination that the Pool is a separate entity under Treas. Reg. §301.7701-1(a)(1), the Pool is an insurance company for purposes of Subchapter L of the Code. Insurance companies are corporations for federal tax purposes. Section 7701(a)(3) and Treas. Reg. §301.7701-2(b)(4). Therefore, the Pool is treated as a corporation for federal income tax purposes. Because the Pool was not created or organized in the United States or under the law of the United States or any state, it is a foreign corporation. Section 7701(a)(5) and Treas. Reg. §301.7701-5. The Pool is thus an insurance company that is a foreign corporation and consequently it is a foreign insurer or reinsurer under Section 4372(a).

As described above, Taxpayer is a Country X insurance company that is treated as a domestic corporation for purposes of the Code. Taxpayer's gross receipts consist of premiums from insurance policies written by Taxpayer to provide insurance coverage for assets, workman's compensation and commercial general liability insurance for affiliated corporations. Taxpayer entered into the Contract with Pool that requires Taxpayer to pay reinsurance premiums to the Pool in exchange for the Pool reinsuring a portion of the insurance risk of Taxpayer from policies issued to affiliated corporations.

Based on the fact that the Pool provided Taxpayer with a policy of reinsurance covering hazards, risks, losses or liabilities wholly or partly within the United States and the determination that the Pool is a foreign insurance company, the excise tax of section 4371 applies to reinsurance premiums paid by Taxpayer to the Pool. This Chief Counsel Advice does not address any exemptions under section 4373 to the excise tax imposed by section 4371.

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Please call (202) 622-3870 if you have any further questions.

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